

# Market Commentary

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## Stocks Strong Out of the Gate

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U.S. stocks started the year strong, with the Dow Jones Industrial Average having its best first quarter in any calendar year since the late 1990s. The Russell 2000 Index was the best-performer among the broad U.S. benchmarks, gaining 7.9% and ending the quarter just 1.4% below its record high of July 2007.

Although delivering positive returns, international stocks trailed U.S. stocks—not surprising given the worsening condition of the EU and the disasters in Japan. Emerging markets stocks eked out a small gain.

Turmoil in the Mideast caused the S&P energy sector to rise 16.3% for the quarter, outperforming all other sectors.

[Continued on Page 3](#)

### Also Inside this Issue

Bonds as a Bedrock of a  
Balanced Portfolio . . . . . 2

U.S. Economic Expansion  
Becoming Self-Sustaining . . 3



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## Quarterly Performance Benchmarks

| <b>Passive Benchmarks*</b>                | <b>Q1-2011</b> | <b>Y-T-D</b> | <b>1 Year</b> | <b>3 Year†</b> | <b>5 Year†</b> |
|---|----------------|--------------|---------------|----------------|----------------|
| S&P 500 Index                             | 5.9            | 5.9          | 15.6          | 2.3            | 2.6            |
| MSCI KLD 400 Social Index                 | 4.3            | 4.3          | 10.5          | 2.3            | 2.4            |
| DJIA (reinvested dividends)               | 7.1            | 7.1          | 16.5          | 3.1            | 4.9            |
| S&P MidCap 400                            | 9.4            | 9.4          | 27.0          | 10.0           | 6.1            |
| Russell 2000 (Small Cap)                  | 7.9            | 7.9          | 25.8          | 8.6            | 3.3            |
| MSCI EAFE (Europe, Australasia, Far East) | 3.5            | 3.5          | 10.9          | -2.5           | 1.8            |
| MSCI Emerging Markets                     | 2.1            | 2.1          | 18.8          | 4.6            | 11.0           |
| Barclays Capital Aggregate Bond           | 0.4            | 0.4          | 5.1           | 5.3            | 6.0            |
| <b>Lipper Mutual Fund Benchmarks*</b>     |                |              |               |                |                |
| Average US Diversified Equity             | 6.2            | 6.2          | 18.1          | 4.2            | 2.6            |
| Large Cap Growth                          | 5.2            | 5.2          | 16.1          | 3.2            | 2.9            |
| Large Cap Value                           | 5.9            | 5.9          | 13.0          | 0.7            | 1.1            |
| Mid Cap Growth                            | 8.2            | 8.2          | 27.5          | 8.1            | 4.4            |
| Mid Cap Value                             | 7.1            | 7.1          | 20.7          | 6.5            | 3.5            |
| Small Cap Core                            | 4.3            | 4.3          | 25.2          | 8.0            | 5.7            |
| International Equity                      | 3.1            | 3.1          | 12.5          | -2.3           | 1.6            |
| Real Estate                               | 6.2            | 6.2          | 23.5          | 1.6            | 0.5            |
| Intermediate-term Bond                    | 0.9            | 0.9          | 6.2           | 5.4            | 5.5            |

Performance data quoted represent past performance and are not guarantees of future results. Investing involves risk, including loss of principal. Passive benchmarks are unmanaged groups of stocks and are not directly available for investment. Lipper Mutual Fund Benchmarks are compiled by Lipper, Inc., a Thomson Reuters company. Information has been obtained from sources considered to be reliable; however, neither First Affirmative nor its agents guarantee the accuracy of the numbers reported.

\* Sources: *The Wall Street Journal*, *The Financial Times*, and MSCI.

† The 3-Year and 5-Year returns are average annual returns for that benchmark.

# Bonds as a Bedrock of a Balanced Portfolio

Charles Sandmel AIF®, CFP®

If you didn't look at bond yields between December 31st and March 31st, you might not think that much had happened over the first quarter. U.S. Treasury rates were nearly the same at the end of the quarter as they were at the beginning. But in between, there was a lot of movement. Dramatic events led to higher volatility without indicating a clear direction.

Total returns for the quarter were mediocre: the Barclays Capital Aggregate Bond Index returned just 0.42%.

Concerns about the creditworthiness of U.S. government obligations appear to be political in nature, not financial. Our view is that investors need not be concerned about the credit risk of U.S. government debt. Interest rates reflect credit quality. The yield on the 10-year U.S. Treasury Note (3.40% on April 5, 2011) is competitive with those of the UK and Germany (3.73% and 3.36%, respectively).

These relationships have not changed materially over the past few years, and they imply that the worldwide market is not scared about the United States. This is not to say that the volume of U.S. government debt isn't staggering, or that constant deficits are acceptable. But, it is clear that we are not in crisis.

Inflation is not pervasive in the developed world, because food and fuel prices—increases which pose a global humanitarian risk—have a limited effect on overall cost of living for wealthy nations. The Federal Reserve has done a far better job at managing U.S. inflation than it has done in achieving full employment. It will likely be awhile before the deflationary effect of the falling prices of homes and slack consumer demand make inflation a material concern.

## Municipal Bonds in the Headlines

The municipal bond market actually outperformed the taxable market last quarter, with the Barclay's Capital

Municipal Bond Index returning 0.51% (but only 1.63% over the past 12 months). This usually dull sector has seen more than its share of headlines, which have resulted in nearly 10% disinvestment in mutual funds over the four months ending March 31, 2011. There are a number of concerns, some of which are real. In our view, some of them have been manufactured to fit an anti-government political agenda.

There have also been many headlines about the fiscal health of state and local pensions. How big the problem is depends on a number of assumptions—and partisans have been known to use assumptions that bolster their arguments.

Legal and practical constraints imply that the number and severity of bankruptcies by traditional local governments should not be material. Unlike corporate bankruptcies, which are common and often entail near-total losses, municipal defaults over the past century have been

transitory and have been cured with minimal losses. Unlike corporations, state and local governments are permanent entities.

With low interest rates and little upside, it is difficult to get excited about bonds today. But there is no reason to move away from them. Bonds still provide income, diversify portfolios, and preserve capital. As

long as investors use bonds appropriately—not to speculate or to compensate for low rates by extending maturity or credit risk—bonds remain a bedrock of the balanced investment approach.

Charles Sandmel is an Investment Advisory Representative of First Affirmative Financial Network, LLC. A 30-year veteran portfolio manager and past Director of the National Federation of Municipal Analysts, Mr. Sandmel manages fixed-income separate accounts for First Affirmative clients.



# Stocks Strong Out of the Gate

Continued from Page 1

The stock market's smooth upward ride began late last summer with the Federal Reserve's bond-buying program ("Quantitative Easing, Part 2"). In late February, with the financial implications of political upheaval in the Middle East (and a related spike in the price of oil) on investors' minds, volatility returned.

On March 11, Japan was rocked by one of the most powerful earthquakes on record. In its aftermath came a deadly tsunami and a continuing crisis at a group of crippled nuclear power plants. Meanwhile, in Europe, Portugal was teetering on the brink of financial insolvency. The effect of such anxiety and uncertainty caused the global financial markets to swoon.

Although Japanese and European markets took the brunt of the selling panic, U.S. investors were not entirely immune. In March, the Dow Jones Industrials had 16 days where the index traded up and down in a triple-digit range over the course of the session—the most such days in a single month since last August.

But as the quarter came to a close, global financial markets quickly found their footing. A steady stream of positive financial reports overcame the bad news and uncertainty overseas, lending support to the view that the global economic recovery is becoming self-sustaining.

## U.S. Economic Expansion Becoming Self-Sustaining

For weeks, the labor market's leading indicators—jobless claims, profit trends, lending standards, etc.—had been providing evidence that private sector job creation was growing. It became official when the Bureau of Labor Statistics reported that 216,000 net new jobs and 230,000 new private sector jobs were created in March, and that the January and February reports had been revised upwards.

An 8.8% unemployment rate (a full percentage point below a year ago), strong manufacturing data, and the March job gains support the view that the economic recovery is gaining traction.

The jobs report also showed stagnant wage growth, which has both positive and negative implications. When workers see more of their disposable income eaten up by higher gasoline and food prices, it affects their discretionary spending, and reduced consumer spending does not help the economy grow. The positive implication is that stagnant wages serve to keep a lid on inflation.

## Fed Policy Shift?

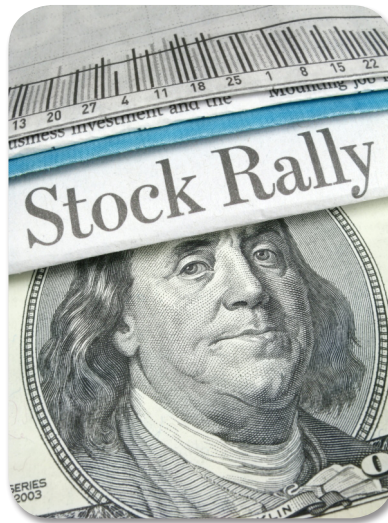
The positive jobs data gives the Federal Reserve room to maneuver. The controversial \$600 billion "QE2"—the Fed's program of buying Treasury bonds—is now more likely to end as scheduled this June. This means the Fed is moving from "easing" to "neutral." Eventually the Fed will move from "neutral" to "tighten" (raising interest rates). But we are not there yet. Not even close.

If the Fed's mandate is to foster maximum sustainable economic growth and reduce unemployment, current conditions (unemployment, the housing market, rising energy prices) indicate that there is a long way to go. Given the many challenges that remain, it is difficult to see any justification for the Fed to raise interest rates any time soon.

## Near-Term Asian Slowdown, Then Expansion

The Japanese economy is contracting. Industrial activity is expected to fall by over 15% during March–April 2011, as compared to the same two-month period a year ago. The impact of the disasters in Japan on the rest of the Asian region will vary, but supply disruptions and weaker Japanese demand will certainly impact the ASEAN manufacturing centers in Taiwan, Malaysia, and Thailand. And high energy prices will likely dampen global discretionary spending and industrial activity.

Despite the enormous human tragedy, the factors currently depressing Japanese activity are short-term in nature. As production resumes over the next few months, economic activity will rebound. Furthermore, major



Continued on Page 4

# Stocks Strong Out of the Gate

Continued from Page 3

restoration and reconstruction projects will improve not only Japan's economy—which is the world's third largest—but also the global economy.

## The Case for Stocks

One can always find reasons to be either pessimistic or optimistic. Certainly our nation is facing considerable fiscal challenges, and those challenges receive plenty of coverage in the media. But there are also many reasons to be optimistic, and these probably don't receive nearly as much attention. Our view is that on balance, the investment climate appears generally favorable for stocks, for these reasons:

- The Fed is unlikely to raise rates soon;
- Core inflation is contained despite higher food and energy prices;
- Financial markets have (mostly) normalized;
- Economic and labor market improvements continue;
- Labor market improvements are especially encouraging;
- Corporate balance sheets are flush with cash;
- Merger and acquisition activity is on the upswing;
- Corporate earnings are rising;
- Stock market valuations are reasonable (the S&P 500 stock index is currently priced at about 14 times expected 2011 earnings); and
- Cash and fixed income investments are relatively unattractive.



## Market Downturns: Inevitable and Unpredictable

Stock prices have doubled since their bear-market low in March 2009. Many investors are concerned that such a strong advance in stock prices suggests danger ahead. The reality is that there is always risk in investing in stocks, no matter how diversified your stock portfolio may be, and no matter how favorable the investment climate.

Corrections and bear markets are inevitable, and investors must expect them and allow for them in the way their portfolios are constructed. Stock market downturns begin and end without warning. Portfolios should be constructed accordingly, which means that they must be diversified among different asset classes in a manner that is appropriate to each investor's objective and to his or her ability and willingness to tolerate different levels of volatility.

Kevin O'Keefe, Chief Investment Officer of First Affirmative Financial Network, LLC, is responsible for due diligence and monitoring of mutual funds and separate account managers.



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